Views on U.S. Department of Labor's Proposed Conflict of Interest Rule

Statement of

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"Hearing on Proposed Conflict of Interest Rule
and Prohibited Transaction Exemptions"
U.S. Department of Labor

August 6, 2015

FILED ELECTRONICALLY

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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington DC 20210

August 6, 2015

Alicia H. Munnell and Anthony Webb submit the following comments on the U.S. Department of Labor's proposed regulations on conflicts of interest and the definition of investment advice. Alicia H. Munnell and Anthony Webb are Director and Senior Research Economist at the Center for Retirement Research at Boston College, respectively.

To summarize, the retirement savings landscape has been transformed since the Employee Retirement Income Security Act (ERISA) was passed in 1974. The displacement of defined benefit pension plans by 401(k) plans has transferred responsibility for investment decisions from employer to employee. Many workers have accumulated plan balances that are insufficient to maintain their standard of living in retirement. Although many factors have contributed to inadequate plan balances, subpar investment returns undoubtedly play a part. Even seemingly small shortfalls in annual returns cumulate over a working lifetime to substantial reductions in wealth at retirement and in post-retirement income.

We believe that conflicted advice significantly reduces returns on self-directed retirement assets. Some in the industry argue that the solution is fuller disclosure. While we have nothing against disclosure, we do not believe that disclosure alone will solve the problem. It is simply asking too much to expect people to read the disclosures, understand them, figure out what action to take, and then implement their decisions.

We strongly support the DOL's proposed regulation, viewing it as carefully crafted, workable, and likely to substantially reduce the harm caused by conflicted advice. We commend the Department for proposing "principles-based" rather than "rules-based" regulation that preserves households' freedom to choose from a wide variety of distribution channels for financial services. We do not believe that the regulation will materially reduce access to advice or that it will result in consumers being forced to switch from commission-based to potentially higher cost fee-based advice. Although financial services providers will incur some compliance costs, we believe these will be extremely small relative to the potential benefits to consumers. Offsetting any compliance costs are the reductions in distribution costs resulting from greater public trust in financial services providers.

Although we support the "light touch" approach embodied in the proposed regulation, we believe the proposal could be strengthened in one important area: the treatments of platform providers. We elaborate on the above points in the following paragraphs.

1. The retirement savings landscape has changed dramatically in the 40 years since ERISA was passed. In 1974, most workers with pensions were covered by defined benefit (DB) plans. At that time, Individual Retirement Accounts (IRAs) held only $3 billion, and section 401(k) of the Internal Revenue code did not exist.[1] In contrast, in 2015, most private sector workers with pensions are covered by 401(k) plans in which participation is voluntary, investment and longevity risk are borne by the participant, and asset allocation and drawdown decisions are placed firmly in the hands of the participant. Furthermore, IRAs, which used to be funded primarily by cash contributions, are now mainly funded by 401(k) rollovers and now contain more retirement savings than 401(k) plans ($7.4 trillion vs $5.4 trillion).[2] Although IRAs now dominate the retirement savings landscape, IRA investors are not accorded ERISA protections under current regulations.

2. The United States faces a retirement saving crisis. Although only a small minority of retirees falls below the poverty line, studies by researchers at the Center for Retirement Research show that only half of working-age households will be able to maintain their standard of living in retirement.[3] The law of compound interest dictates that even seemingly small differences in annual net-of-fee investment returns have a significant effect on retirement wealth and post-retirement income. To illustrate, a 1 percent reduction in net-of-fee returns reduces wealth at retirement by about 20 percent and retirement income by more than one-third.[4]

3. The Council of Economic Advisers (CEA) recently published a report that surveyed the substantial academic literature on the prevalence and cost of conflicted advice.[5] The report concluded that conflicted advice reduced net-of-fee returns by about 1 percent a year. This reflected both high fees and subpar returns. The CEA estimated that about $1.7 trillion of IRA assets was invested in products that generate conflicts of interest. Thus, they estimated the cost of conflicts of interest at about $17 billion a year.

To put this number in context, the tax expenditure on 401(k) and IRA plans is about $62 billion a year.[6] Thus, between one-quarter and one-third of the tax expenditure is lost as a result of sub-par returns.

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[1] Investment Company Institute. 2009. "The Evolving Role of IRAs in U.S. Retirement Planning." *Research Perspective* 15(3): 1-30.

[2] U.S. Board of Governors of the Federal Reserve System. *Flow of Funds Accounts of the United States*, 2014. Washington, DC.

[3] Munnell, Alicia H., Matthew S. Rutledge, and Anthony Webb. 2014. "Are Retirees Falling Short? Reconciling the Conflicting Evidence." Working Paper 2014-16. Chestnut Hill, MA: Center for Retirement Research at Boston College.

[4] The above calculation compares a base case of a 4.5-percent real return over 30 years followed by withdrawals of 4 percent of retirement wealth with an alternative of a 3.5-percent real return followed by withdrawals of 3 percent (4 percent minus 1-percent additional fees).

[5] Council of Economic Advisers. 2015. "The Effects of Conflicted Investment Advice on Retirement Savings." Available at: https://www.whitehouse.gov/blog/2015/02/23/effects-conflicted-investment-advice-retirement-savings.

[6] Munnell, Alicia H., Laura Quinby, and Anthony Webb. 2012. "What's the Tax Advantage of 401(k)s?" *Issue in Brief* 12-4. Chestnut Hill, MA: Center for Retirement Research at Boston College.

In general, we endorse the findings of the CEA report. But we identify three factors that contribute to the report understating the extent of the harm caused by conflicted advice. First, the analysis covers only IRAs. Not all 401(k) plans are high quality, and conflicted advice likely also contributes to excessive fees and poor returns in 401(k)s. Even conditioning on plan size, plan costs vary significantly.[7] Second, the $1.7 trillion CEA estimate of assets invested in conflicted products excludes advised assets other than load mutual funds and annuities and implicitly assumes that these excluded assets are not subject to conflicted advice. Yet the academic literature demonstrates that investment advisors managing directly held stock portfolios often trade excessively, incur unnecessary fees, and produce lower returns than would be obtained from a buy-and-hold strategy.[8] Third, the CEA's estimate of the cost of conflicted advice likely represents a lower bound. Some studies of broker-sold mutual funds report much higher costs. Furthermore, $600 billion of the $1.7 trillion is invested in annuities, many of which have high sales loads, opaque annual charges, and high surrender fees.

The literature cited in the CEA report features prominently in the DOL's Regulatory Impact Assessment (RIA). The RIA yields substantially smaller benefits than $17 billion a year in part, because the RIA assumes that investors will only gradually switch to better-performing funds. In contrast, the industry will immediately face full compliance costs. But the RIA nonetheless shows a substantial excess of benefits over costs over a 10-year horizon: $40-44 billion of benefits and $2.4-5.7 billion of costs.

The Investment Company Institute (ICI) has challenged the CEA report's interpretation of the literature.[9] ICI testimony argues that the studies only indirectly address the question of whether participant outcomes would be improved were their advisors to be held to a fiduciary standard. This is true, because the academic literature compares broker-sold with direct-sold funds, rather than broker-sold funds with funds recommended by a fiduciary. But if there is a bias, it will be in the direction of understating the performance gap, because households receiving fiduciary advice are likely to do at least as well as, if not better than, unadvised households.

ICI points out that the academic studies mostly used data from the 1990s and early 2000s. It then argues that the mutual fund market has changed fundamentally and that the studies therefore have little relevance to current conditions. We disagree. Although some high-fee funds may outperform, high fees will, on average, lead to poor net-of-fee returns.

In fact, the academic studies show that the underperformance of broker-sold funds actually exceeds the additional fees. But suppose that the pre-fee returns of broker-sold funds were identical to those of direct-sold funds. In this case, it could be argued that high fees do no more than compensate brokers for the high costs of doing business with the types of households that invest in broker-sold funds. This argument might have merit if households were well informed about fees. But when households are ignorant of fees, advisors have an incentive to increase

[7] Huntley, David W. and Joseph W. Valletta, eds. 2015. *The 401(k) Averages Book*. Baltimore, MD: Pension Data Source, Inc.

[8] Hackethal, Andreas, Michael Haliassos, and Tullio Jappelli. 2012. "Financial Advisors: A Case of Babysitters?" *Journal of Banking & Finance* 36(2): 509-524.

[9] For example, see the written testimony of the Investment Company Institute, 2015.

sales and marketing expenses and recoup these expenses through higher fees. The level of such expenses will be inefficiently high.

4. Officials at the Department of Labor gave appropriate consideration to whether their regulatory objective could be met by disclosure alone. They concluded that disclosure would likely be ineffective. "Extensive research has demonstrated that most investors have little understanding of their advisors' conflicts, and little awareness of what they are paying via indirect channels for the conflicted advice. Even if they understand the scope of their advisors' conflicts, most consumers generally cannot distinguish good advice, or even good investment results, from bad."[10] We agree. A substantial literature documents very low standards of financial literacy. If households do not understand basic financial concepts such as percentages and compound interest and do not know the difference between a stock and a bond, they are unlikely to understand the disclosure.[11] But we would go further. We believe it is unlikely that the disclosures would be read in the first place and equally unlikely that many households would be able to implement the requisite changes.

5. Since disclosure alone will not work, we need regulation. The proposed regulation replaces the existing five-part test for determining fiduciary status with a new four-part test. The regulation applies this test not only to 401(k)s but also to IRAs and IRA rollovers. It then creates six carve-outs. If a provider of financial services falls within one of the carve-outs, it will not be deemed to be a fiduciary. Finally, the regulation creates exemptions, the most important of which is the Best Interest Contract (BIC) exemption. The BIC exemption permits fiduciaries to receive commissions, subject to conditions designed to safeguard investors.

6. We strongly support the new four-part test. Under the existing five-part test, advisors must: 1) make investment recommendations; 2) on a regular basis; 3) with a mutual understanding that they will be relied upon; 4) as the primary basis for the investor's decisions; and 5) be individualized to the needs of the investor. This test is a broken reed in that advisors can easily escape fiduciary status by claiming that there was no mutual understanding that the advice should form the primary basis of the investor's decisions.

Under the proposed four-part test, the advisor must 1) make covered recommendations; 2) with an understanding only on the part of the recipient of the advice; 3) that the advice is either individualized or specifically directed to the recipient; and 4) that the advice will be considered but will not necessarily form the primary basis for the investor's decision. The change in language will prevent advisors from avoiding being held to the fiduciary standard, because mutual understanding and primary basis will no longer be required.

7. Advisors will be held to the fiduciary standard with respect to not only 401(k) assets but also distributions from 401(k) plans and IRA assets. Extending coverage to IRA assets seems logical, given that both 401(k)s and IRAs are integral and equally important parts of the retirement income system. Advisors have strong incentives to encourage rollovers from 401(k) plans to

[10] *Federal Register* 80(75): 21, 952.
[11] For example, Lusardi, Annamaria, Olivia Mitchell, and Vilsa Curto. 2009. "Financial Literacy and Financial Sophistication among Older Americans." Working Paper 15,469. Cambridge, MA: National Bureau of Economic Research.

IRAs, given that they can earn fees and commissions on the latter but are unlikely to do so on the former. 401(k) plans often, but not always, have lower fees than IRAs, and the proposed regulation will compel advisors to carefully consider and document whether any benefit from rolling over 401(k) assets is likely to compensate for any increase in fees.

8. Six “carve-outs” in the proposed regulation exclude persons and activities from the fiduciary rule: 1) counterparties to large plans; 2) swap counterparties; 3) employees of the plan sponsor; 4) platform providers; 5) financial valuations and appraisals; and 6) investment education.

While carve-outs mostly cover situations in which fiduciary status would not be appropriate, we have serious concerns with the carve-out for platform providers. Research shows that mutual fund families acting as trustees for 401(k) plans favor their own affiliated funds, particularly their poorly performing funds, to the detriment of plan participants.[12] Furthermore, platform providers are often 401(k) plan participants’ primary source of contact with their plan, both during their employment and also when contemplating rollover on termination of their employment. The regulation, nevertheless, provides a carve-out. As long as the platform provider discloses that it does not provide impartial fiduciary advice, it can identify investment alternatives that meet objective criteria specified by the plan fiduciary.

We would favor eliminating this carve-out. As an alternative, the United States could either follow U.K. practice and prohibit platform providers from receiving fees or alternatively create an exemption similar to that applied to broker-dealers. Another alternative would be to restrict the carve-out to platforms servicing large plans. And the carve-out should definitely not be extended to platforms servicing IRAs, where protections are weaker.

9. The prohibited transaction rule prohibits fiduciaries from receiving commissions. To permit the continued use of commission-based distribution channels, the proposed regulation creates a BIC exemption. Advisors may continue to receive commissions, provided they comply with certain conditions. The principal requirements for exemption are that the advisor enters into a written contract with the client, maintains a website disclosing compensation, discloses the costs associated with the client’s investments, receives no more than reasonable compensation and, subject to a further exemption, offers a broad range of investments.

In contrast to reforms in other countries, this effort is very much light-touch regulation. The argument could be made that we should have followed the example of the United Kingdom and elsewhere and eliminated sales commissions altogether. But officials at the DOL made a judgment call that they could secure their objective through less intrusive regulation, and we support their decision.

Some parts of the industry argue that the BIC exemption is unworkable and will lead to advisors abandoning large segments of the population and pushing others into more expensive fee-based advice. If one is willing to make really extreme assumptions about the number of people who might lose access to advice and about the effect of that advice on investor behavior, it is easy to show that the cost of the regulation will exceed the benefits.

[12] Pool, Veronika Krepely, Clemens Slaim, and Irina Stefanescu. 2015 (forthcoming). “It Pays to Set the Menu: Mutual Fund Options in 401(k) Plans.” *Journal of Finance*.

But these assumptions are simply not credible. We are being asked to believe that the terms of the BIC exemption are so onerous that the industry will choose to walk away from $1.7 trillion of assets and perhaps $17 billion of revenue rather than comply with them. We are also asked to believe that households that lose access to advice will then make egregious investment mistakes. No real evidence exists to support either of these claims.

What the industry characterizes as insuperable obstacles are, in our view, just minor wrinkles. We have no doubt that the regulation could be improved. But we believe that the overall structure is correct and that only minor tweaking is required.

To illustrate, the exemption requires the adviser to disclose the fees on an investment over a holding period. The industry argues that making such an estimate is impossible because: 1) the cost depends on the return and the holding period, neither of which is known in advance; 2) different companies would be making different assumptions; and 3) any assumptions might conflict with FINRA guidelines. All of these concerns are valid. But these problems are not insoluble. One might, for example, require companies to use "reasonable" assumptions.

But a question arises – what use will the disclosures under the BIC exemption serve if investors either do not read them or do not understand them? We believe the disclosures do serve a useful purpose in that they make it easier for investors to obtain legal redress for misconduct and make misconduct less likely in the first place.

To illustrate again, some in the industry argue that requiring the advisor to enter into a written contract will expose the advisor to litigation for breach of contract and that fear of litigation will result in advisors withdrawing from the market. We believe that entering into a written contract will, if anything, reduce the risk of litigation, by reducing the scope for misunderstandings as to the terms of the engagement.

Testimony by the industry argues that if advice is no longer available, households will save less, may panic and sell during market downturns, may fail to rebalance, and may fail to save sufficiently for their retirement. But no robust evidence exists for any of these claims.

The industry points to the fact that households with financial advisors have greater wealth. But we cannot infer from this correlation that financial advice causes an increase in saving. It is more likely that households that are already wealthy or already have a strong taste for saving are more likely to seek advice or be sought out by advisors.

We are unaware of any rigorous study showing that advised households are less likely to sell during downturns. To the contrary, one recent study found that, if anything, advisors reinforce biases and misperceptions.[13] And a recent study using Vanguard data found that 401(k)

[13] Mullainathan, Sendhil, Markus Noeth, and Antoinette Schoar. 2012. "The Market for Financial Advice: An Audit Study." Working Paper 17,929. Cambridge, MA: National Bureau of Economic Research.

participants, who by and large would not have financial advisors, were if anything gripped by inertia during the recent financial crisis.[14]

The RIA cost-benefit analysis omits an important factor. Households, especially low socioeconomic-status households, are often distrustful of financial services providers. This lack of trust increases distribution costs and reduces profits. The behavior of a minority of "bad actors" imposes costs on the remainder of the industry. To the extent that the regulation improves the quality of advice, it will increase trust and decrease costs. It is not inconceivable that the benefit to the industry from increased trust may exceed the compliance costs.

To summarize, we view the proposed regulation as a carefully crafted attempt to address a serious problem. We believe the Department of Labor has struck a nice balance between doing enough to be reasonably certain of improving conduct and not doing so much that it limits consumer choice as to how they receive financial advice.

We appreciate the opportunity to comment on the proposed regulation. If you have any questions regarding our comments or require further information, please contact Alicia Munnell at (617) 552-1934 or munnell@bc.edu or Anthony Webb at (617) 552-8782 or webbaa@bc.edu.

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[14] Tang, Ning, Olivia S. Mitchell, and Stephen P. Utkus. 2012. "Trading in 401(k) Plans During the Financial Crisis." In *Reshaping Retirement Security*, edited by Raimond Maurer, Olivia S. Mitchell, and Mark J. Warshawsky, 101-119. Oxford, UK: *Oxford University Press*.